MONEY AND DEBT RANGES
FOMC BRIEFING
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The choice regarding annual ranges for broad money and debt conjures up a sense of deja vu. The staff is again projecting that growth in M2 will be near and M3 a little above the upper ends of their respective ranges for this year. Moreover, the picture does not change greatly for next year, measured against the current ranges which were first selected in mid-1995. In contrast, debt of domestic nonfinancial sectors continues to expand around the midpoint of the 3 to 7 percent range that was first adopted at the beginning of 1995.

Perhaps the best way to examine these projections is to begin with debt. The top panel of your first exhibit shows that we expect debt this year and next to continue growing in the 4-1/2 to 5-1/2 percent shaded area that has characterized the period since 1990. This is close to projected growth in nominal GDP this year and a little faster than GDP next year. The composition of total debt growth, however, is shifting a little from federal, the thin line, to private borrowing. Within the private sector, borrowing by businesses is expected to be boosted by healthy gains in capital outlays, in the context of little further improvement in internally generated funds, while household debt decelerates further but continues to outpace income. In the period ahead, we see private sector borrowing restrained only fractionally by a shift by creditors away from accommodation toward snugging. With banks and thrifts healthy and lending continuing to be profitable, even as credit quality erodes a bit, we foresee depository credit growing in line with or a touch faster than debt over these two years, as shown by the thin line in the lower panel.

The top panel of your next exhibit illustrates the staff's projected funding by banks and thrifts of those depository credit flows. The M3 funding of depository credit, the shaded portion of the bars, picked up in 1995 around the time that depository credit moved higher. In particular, issuance of large time deposits, shown in the center panel for commercial banks, reversed course and has risen smartly ever since. Last year, M3 was lifted by some substitution of CDs for liabilities to foreign offices, the broken line, although that runoff may be drawing to an end, perhaps owing to the pickup in credit this year that needs to be financed. We expect recent funding patterns, with a considerable emphasis on M3 sources, to persist through next year.

We also expect that money market mutual funds in M3, shown in the memo line of the lower panel, will continue to grow very rapidly reflecting to their popularity for liquidity management, imparting some upward thrust to M3. As a consequence, the staff projects that M3 will grow 6-1/2 percent this year and 6 percent next year, also shown in the lower panel, extending to four the number of consecutive years of M3 growth in the 6 to 6-3/4 percent area.

Probably of more importance to the Committee is M2 and the issue of whether its recent behavior has been in line with a more traditional velocity relationship. Exhibit 3 plots the now-familiar relationship between M2 velocity, the vertical axis, and a measure of opportunity costs, the horizontal axis, and is the same as chart 6 in the bluebook. As illustrated in the upper panel, along the top line, recent observations remain in the cluster that has characterized the period since mid-1994, which is amplified in the lower panel. The implied velocity relationship--as embodied in the slope of the line--has properties that are quite similar to the one that characterized the three-decade period ending in the late 1980s, the lower line in the upper panel.

--The incoming evidence on the M2 relationship has, indeed, been encouraging. Staff analysis suggests that, in addition to a similar relationship with opportunity costs as before, recent experience has been consistent with less noise in the V2-opportunity cost relationship and a prompter response of M2 to movements in interest rates and income than before.

Nonetheless, the period of closer fit still is quite short in terms of statistical reliability, and one that has been on the tranquil side of longer historical experience. Moreover, the financial environment has changed in some important ways since the late 1980s, such as the much greater availability and lower transactions costs of long-term mutual funds, which as an analytical matter might suggest changes in velocity behavior. These considerations would seem to argue for continued caution in viewing M2 as a serious guide to policy or a key indicator of economic developments, although continued stability and predictability might suggest that unexpected movements in this aggregate deserve some weight in the constellation of indicators that you rely on in assessing economic and price trends.

Our forecast of growth in M2 for this year, 4-1/2 percent, falls a little shy of that of income and thus our expected Q4 velocity in the lower panel, shown by a red X, stands a little above that of Q4:1996. Next year, we are projecting that M2 growth, at 4 percent, will again fall short of income, implying a value of V2 for Q4:1998 shown by the other red X. The rise in V2 next year owes to some assumed monetary tightening over the second half of the year.

In view of these various considerations, the staff has suggested two alternative sets of ranges, shown on exhibit 4, which also appear on page 20 of the bluebook. Alternative-I ranges are those adopted for 1997 by the Committee in February, and alternative II ranges are higher by 1 percentage point for M2 and 2 percentage points for M3, better centering them on staff projections both for this year and next. The suggested range for debt is the same under both alternatives. I would note that your central tendency for growth in nominal GDP, shown as a memo line, brackets the staff forecast for this year but is a little higher for next year. This implies that if your financial assumptions are similar to those of the staff, your expectations for money and debt growth, based on normal velocity behavior, are similar to those of the staff for this year but perhaps a bit stronger for 1998.

Should the Committee believe that velocity relationships are still rather uncertain and that the most effective role for the ranges continues to be as benchmarks of monetary growth under price stability and historically normal velocity behavior, then alternative I would again seem to be favored, both for 1997 and 1998. The midpoint of alternative I for M2 is 3 percent, close to staff's expectation of nominal GDP growth under price stability. Because we would also expect debt growth to average around 3 percent in these circumstances--the bottom of the current debt range--the Committee might want to consider lowering the range for debt to that of M2, were the debt range, too, to be viewed as a benchmark under price stability. However, changing any of the ranges could run the risk of being construed by the public as suggesting that the Committee would be placing greater emphasis on the money or debt aggregates in its conduct of policy than it has in recent years.

Should the Committee instead wish to announce ranges consistent with its <u>expectations</u> for money and debt growth, it still could choose between alternatives I and II. Alternative I ranges might be favored in this context if the Committee thought that velocity relationships had become reasonably predictable again and it wanted the ranges to convey expectations of money growth under a relatively tight policy stance designed to lean against upward inflationary pressures. Were there concerns that a boom economy might be in the offing, M2 in that event would likely breach the upper end of the alternative I range, providing a further rationale for imposing more monetary restraint.

Alternative II ranges are better centered on staff projections, given the Greenbook forecast and its financial assumptions. Moreover, they might be viewed as more consistent with the Committee's expectations for 1998, given your central tendency for nominal GDP growth. Furthermore, alternative II ranges provide greater scope for real output to expand in line with favorable supply shocks to the economy as well as a little more headroom if the Committee foresaw turbulence in equity markets as a distinct possibility and the monetary aggregates becoming a likely refuge for shell-shocked investors.

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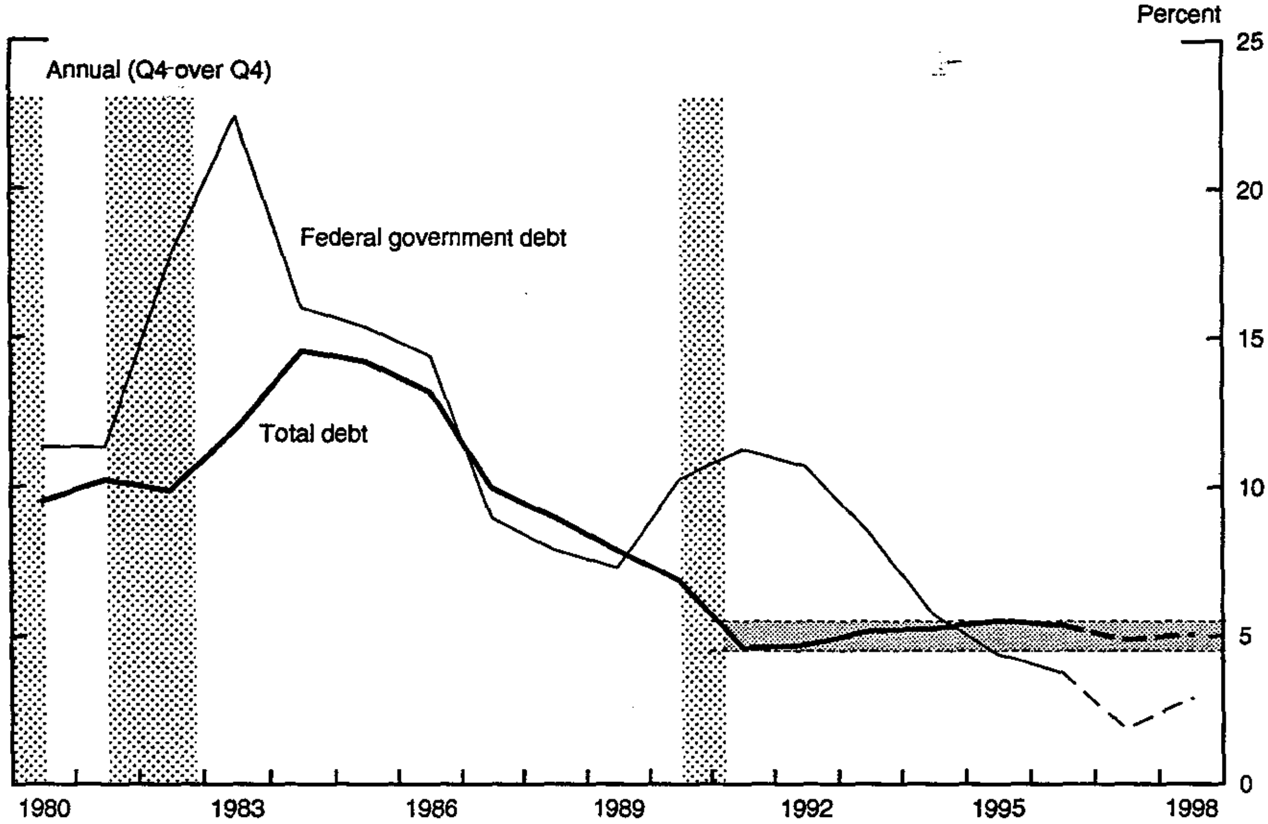
MATERIAL FOR STAFF PRESENTATION ON MONEY AND DEBT RANGES

July 1–2, 1997

Exhibit 1

Domestic Nonfinancial Debt

Growth of Total Debt and Federal Component



Growth of Total Debt and Depository Credit

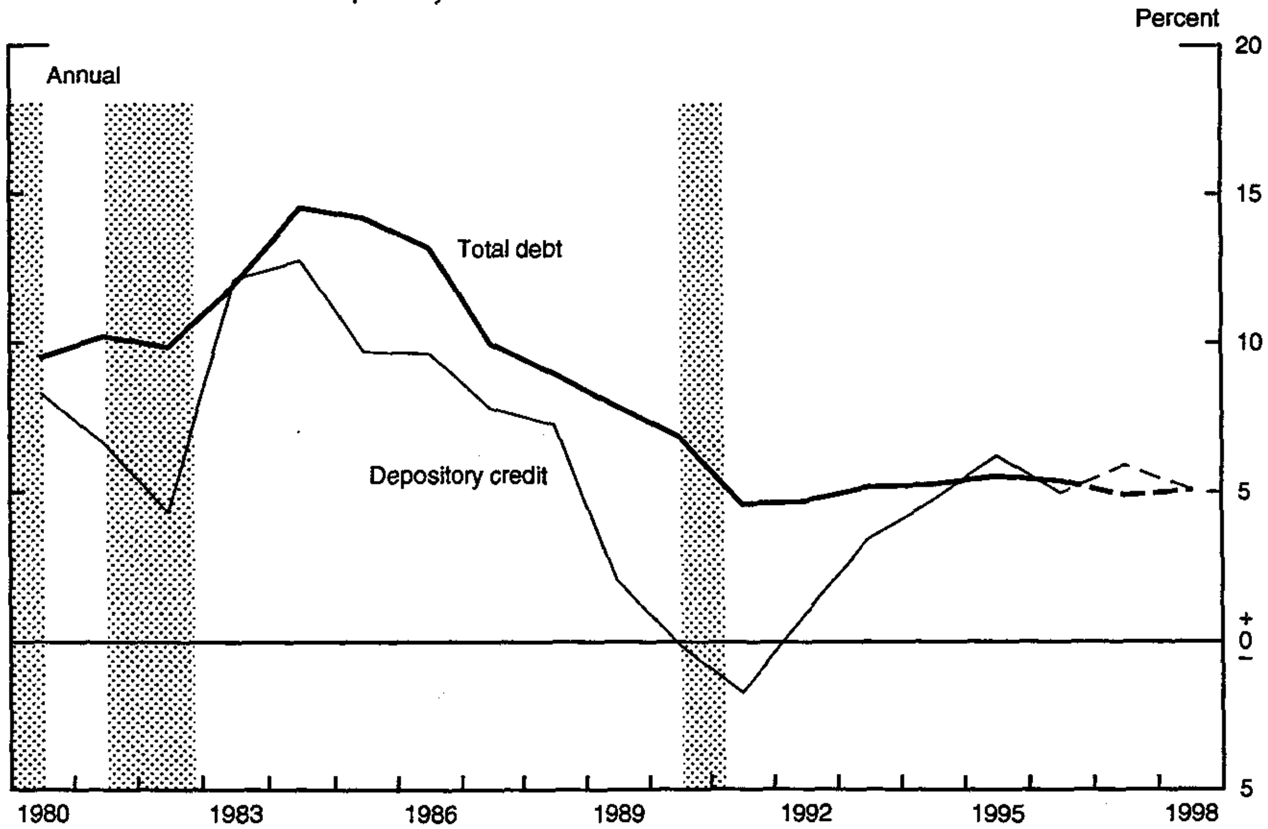
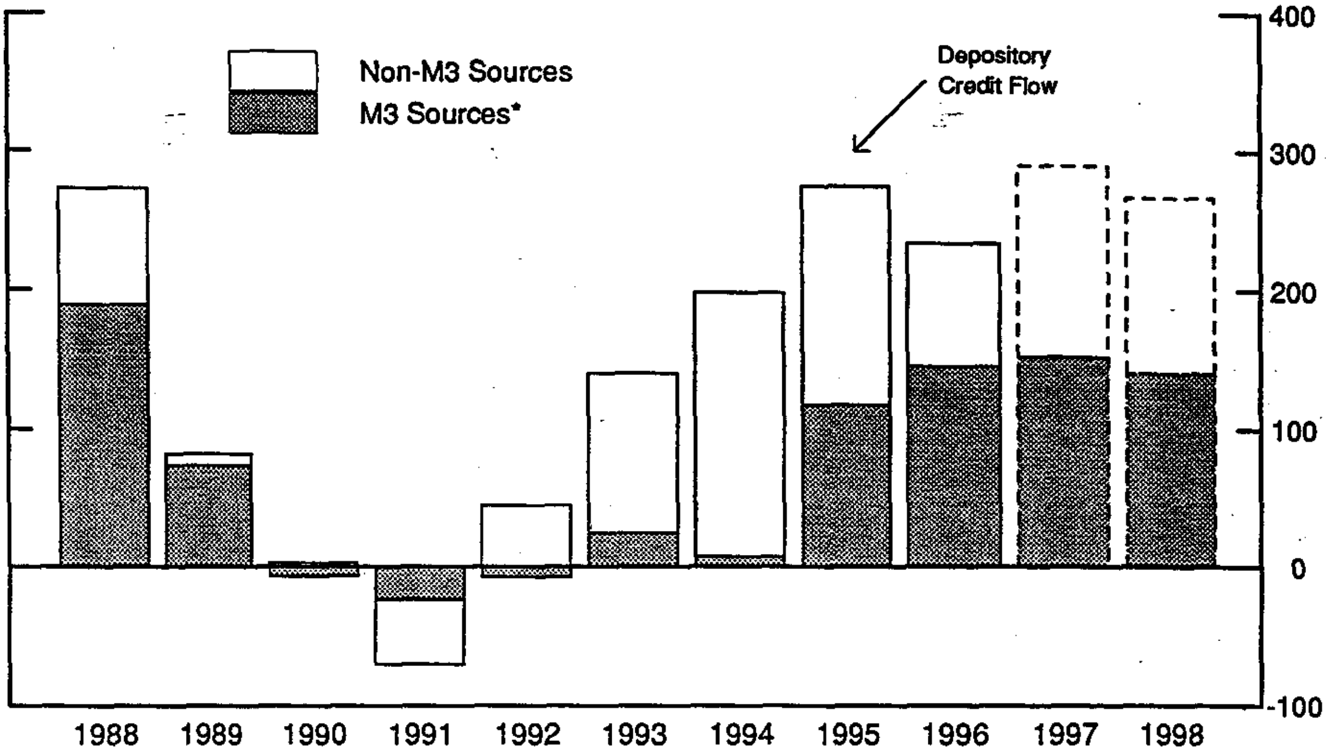


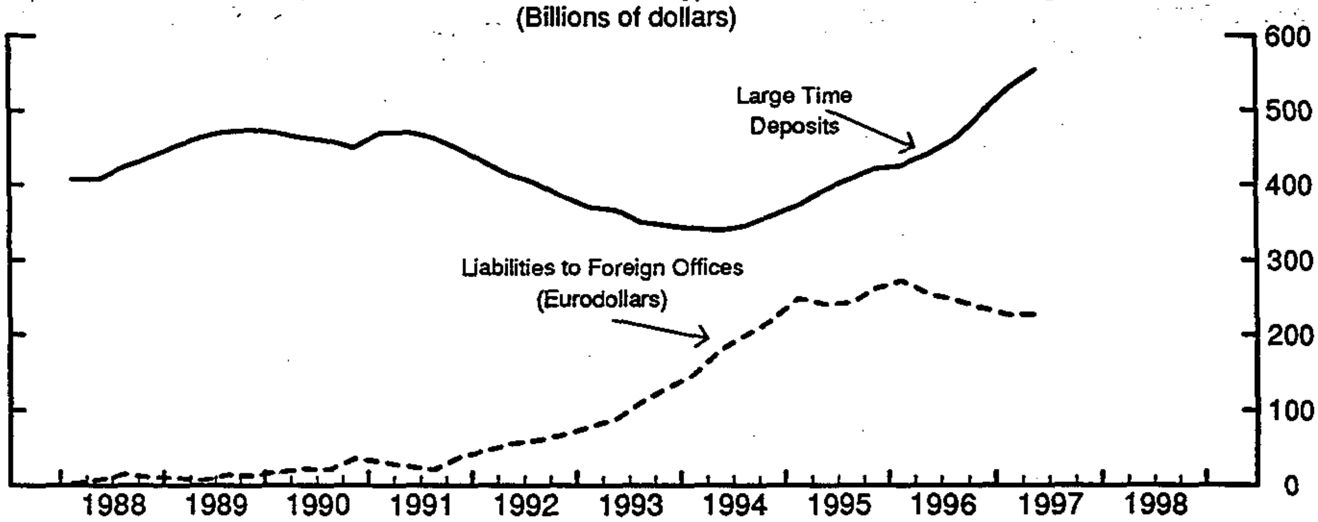
Exhibit 2

Flows of Depository Credit and M3 and Non-M3 Sources of Funding
(Billions of dollars)



*M3 sources are M2 deposits, large time deposits and RPs

Selected Commercial Bank Managed Liabilities Outstanding
(Billions of dollars)



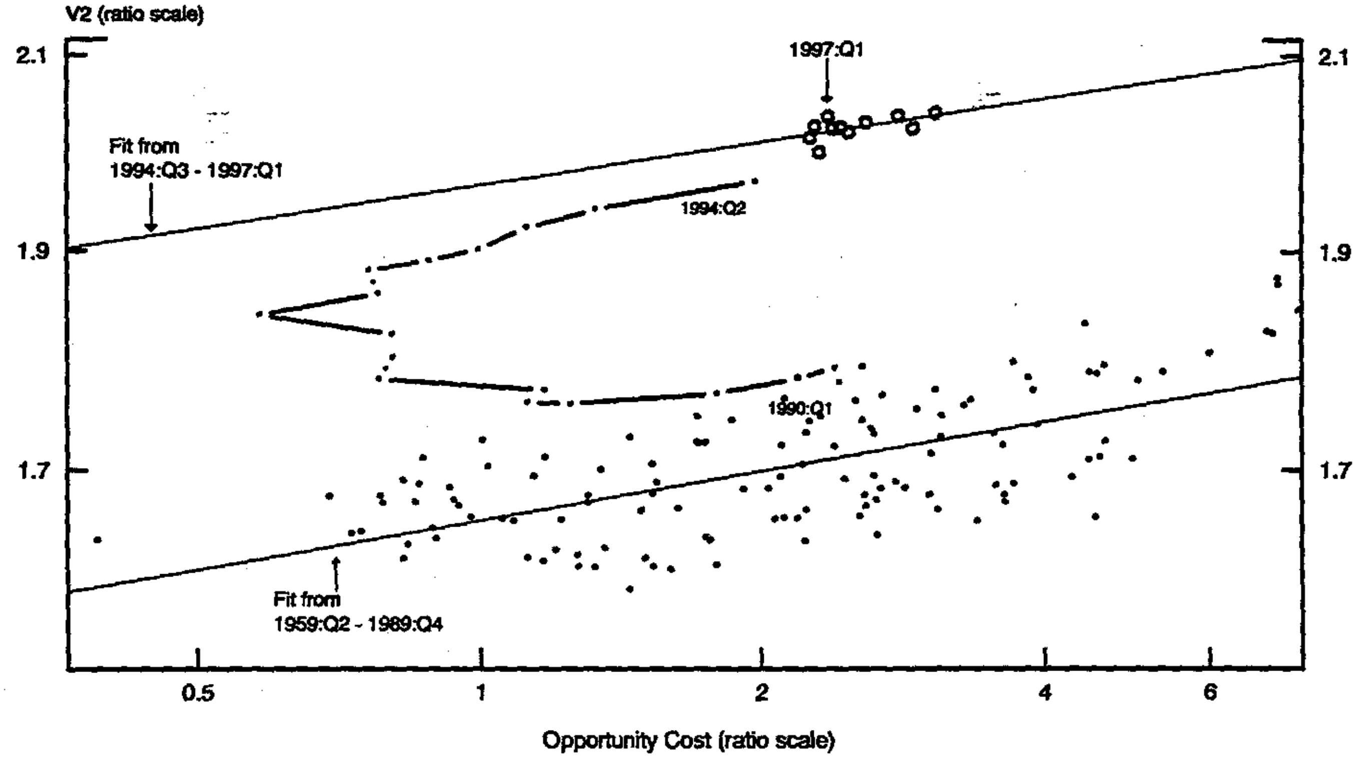
GROWTH IN M3
(Percent)

	1993	1994	1995	1996	Projection 1997	Projection 1998
M3	1.1	1.7	6.2	6.8	6–1/2	6
Memo:						
M3 money funds	–2	–5	24	20	15	16

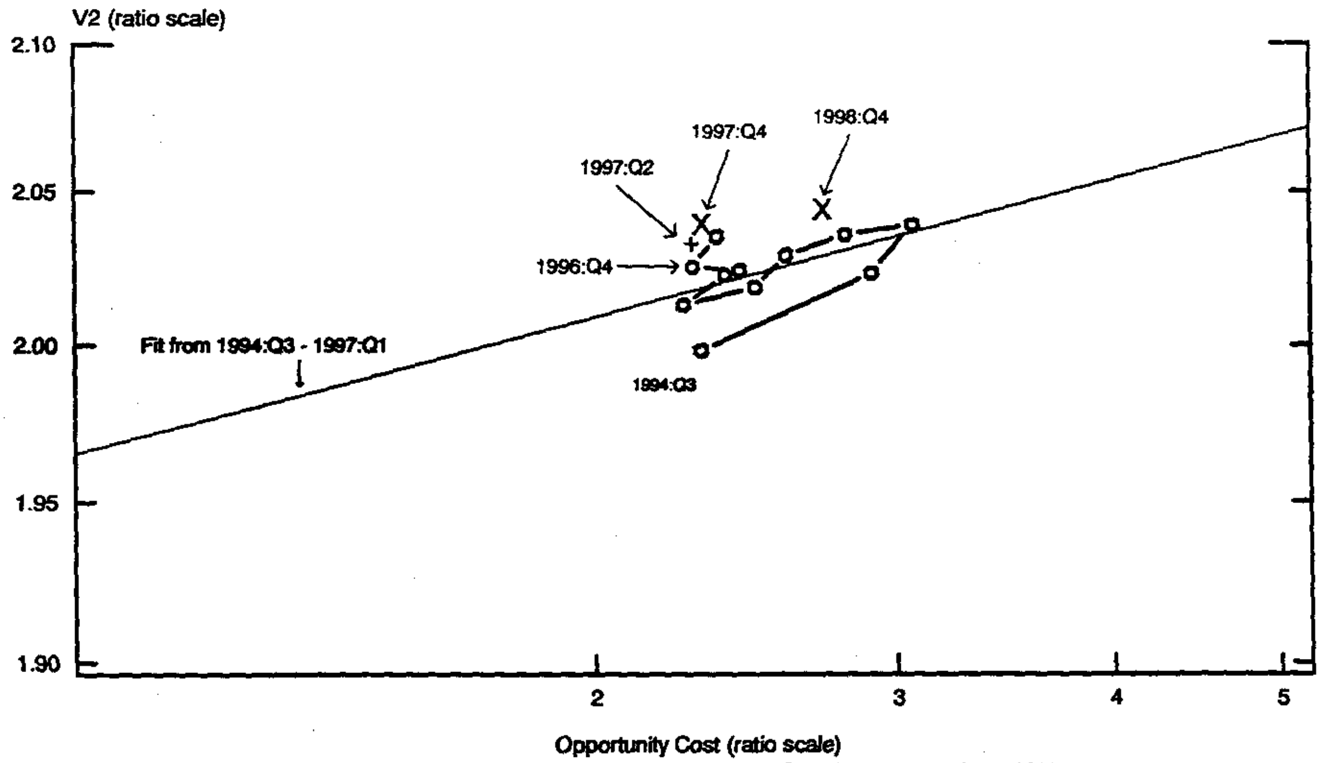
Exhibit 3

M2 Velocity and Opportunity Cost

1959:Q1-1997:Q1



1994:Q3-1997:Q2; 1997:Q4, 1998:Q4



+ -- 1997:Q2 observation based on Greenbook forecast for nominal GDP and partially projected M2.
X -- 1997:Q4 and 1998:Q4 observations based on Greenbook forecasts for nominal GDP and projections of M2.

Exhibit 4

GROWTH OF MONEY AND DEBT AND ALTERNATIVE RANGES
(Percent)

	1997 (Projected)	1998 (Projected)	Alternative I	Alternative II
M2	4–1/2	4	1 to 5	2 to 6
M3	6–1/2	6	2 to 6	4 to 8
Debt	5	5	3 to 7	3 to 7
Memo: Nominal GDP				
Staff projection	5–1/2	4–1/4		
FOMC central tendency	5 to 5–1/2	4–1/2 to 5		